THE EQUUS REPORT

—BY BARNABY LEVIN

Risk & Reward

Where and How to Invest in
Today's Environment

February 1, 2023

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RISK & REWARD – Where and How to Invest in Today's Environment

In 2022, the Nasdaq had its worst year since 2008 and the Dot-Com Bust of 2000. Stalwarts (from Amazon and FedEx to Google and Disney) fell 30, 40 and 50% – while smaller companies (from Coinbase and Rivian, to Snap) were down more than 80%.[1] Some (like Tesla) held up relatively well, all year long – until November, when (for various reasons) they simply "gave up the ghost." But the one thing that seemed to take most people by surprise was Bonds. In aggregate, they were down ***27.5%***! Now, we've been warning this might happen (for quite some time) but given the fact it (now) has, now might be a good time to discuss the whole ***concept*** of **Risk** & **Reward.**

We know, for example – if you want the ***potential*** of greater reward – one ***must*** take greater **risk**, right? But as I just said of bonds, what *most* consider "**Low** Risk" or "***Conservative***" no longer **is**.

In a recent study by S&P – given last year's losses in both stocks *and* bonds – investing in a broad array of diversified funds ("passive" *or* "active") didn't help. Even with Energy up 60%, the S&P only started the year with a 3% allocation in the Index – so even a gain of that magnitude didn't help and, with the frequent changes in trend throughout the year, the Market caught most Managers flat footed (*except*, perhaps, for Macro Hedge Funds who "***shorted***" the Market).

But "Fear of Missing Out," by day traders and mutual funds, led to the flip side of taking on too much risk which, during a long period of Zero Interest rates, saw the price and valuation of everything from stocks, bonds and real estate – to Art and "Non-Fungible Tokens" – rise to excess. It seems when people are making money, they can sometimes forget there are ***always*** all ***kinds*** of risks to look out for, so let's examine that thought.

We've all read how even (supposedly) "well-managed" financial firms (like Goldman Sachs) are cutting bonuses. But this, in fact, is something brokerage firms do over and over – over hiring in boom times (like they did in 1999 and early 2000) and, then (when the bubble bursts) going through wave after wave of "RIFs" or "Redundancies" (a common euphemism for mass layoffs, to make it sound more "palatable" from a PR point of view). Meanwhile, tech companies (from Meta and Intel, to Amazon) have

[1] Layoff.fyi

been laying off 10, 15 and 20% of their ranks, which they built during the Pandemic, in a mad dash to meet Demand or (in the case of some, like Salesforce) acquisitions they *thought* they could grow *into*, if things continued like they were. Given their size, however, these layoffs are beginning to add up and, while "talent" might ***still*** be in "short supply," inflation and Supply/Demand imbalances are beginning to create headwinds – while in Europe, they're already in or on the verge of recession.

So, why do we mention this? For one thing, CEO surveys (here in the US) show most are already preparing for a downturn (if not a downright recession) which (of course) affects their ***own*** investment and spending decisions for the year ahead. Lending and Credit, in most areas of the economy (with housing a prime example) have slowed or come to a stop – and real estate which (so many say) "never goes down," ***has***, as young people can no longer afford the price or payment. So as we've been saying, we've already reached the point where (in my opinion) the Fed has gone far enough – and the twin pillars of M2 Money Supply and "Demand Destruction" can take it from here, when it comes to inflation falling further, going forward.

Our mission, in these Reports and my Podcasts with Laurie, is to educate – to help Clients, readers and listeners make ***informed*** decisions – ***whatever*** stage of life they're in and, thereby, grow their wealth, while maintaining financial security, every step of the way. And in our opinion, the best place to start this conversation is by understanding what "Risk" ***truly*** means, for ***you***.

But as I said earlier, what most people consider "low-risk" these days, no longer ***is*** – and that's a ***problem***. Not only because it's what we base our investment decisions on – but because defining Risk "***emotionally***" is as important as it is "***monetarily***." They can be quite different, but both are critical to your well-being.

A few of the more *traditional* categories include things like **Inflation Risk**, which can determine what a good or service you purchase today will cost you years from now. This is important, when trying to figure out what it will take for you to retire. And (in this regard) **Interest Rate Risk** plays a part as well – especially when rates are (as they have been) rising faster than they have in 40 years. If that *continues* (of course) any attempt to make credible projections – of what it will cost to live twenty or thirty years from ***now*** – may be an exercise in futility.

If inflation ***does*** continue to rise the way it has, you can forget about things like Financial Planning Software or Monte Carlo simulations. Because – if you're using returns for the ***past*** twenty years (when interest rates were declining and, for several years, remained near zero) when calculating the "***expected*** rate of return" (regardless of Asset Class) twenty years from ***now***, you can see how the odds your calculations will be off might increase *substantially*, when it will be too late (because, by *then*, you'll *be* retired). ***This*** is why we feel so strongly that young people today need more (not less) of an emphasis on basic math and financial skills. To help them make good choices, when making decisions, like whether it's better to rent or buy a home; to buy or lease a car; or if going to college will be worthwhile, when taking Student Debt into account.

In 2008, Dan Ariely wrote a wonderful book, titled "Predictably Irrational," in which he took a look at how context and comparison influence our decision making. He showed how first decisions can be so important and (as we often point out, when it comes to things like Bias and Assumptions), they (often incorrectly) impact our decisions for the rest of our lives. He points out how our emotions bring out the "Jekyll and Hyde" in all of us ***and*** how the desire for short-term gain over long-term benefits may lead a person to save less. The truth is, we often inflate the value of our belongings and fear giving them up – or we try to keep as many opportunities open as possible (instead of making a choice and committing, when those "opportunities" may have little, actual value) because we ***may*** (one day) regret it.

Suffice to say, after the damage done last year, we all feel the "loss," versus what we had at the peak, in 2021. The gains we enjoyed were ***supposed*** to be locked in "forever" – and it doesn't matter that, in many cases, the price of many things are back where they were, as well – back to where they were pre-Pandemic, including the price of lumber, now back under $500 (from over $1,400) per 1000 board feet, or West-Texas Crude at $75, where it was in 2006, '09 and '14.

But when it comes to things like food and housing – for ***those*** (while prices may have come down a bit), it's all about "affordability." Again – between the price of a home and today's mortgage rates – buying a home may be out of reach and the cost of food is forcing many people to make choices they didn't have to make before. This may be why many Millennials and Gen Z are so vocal about Pay and Work-Life balance.

In other words, it isn't ***all*** about a sense of entitlement!

But those "discussions" they're having with Management won't (from this point) be ***quite*** as easy any more – because companies are getting squeezed on all sides. Labor costs (whether "fair" yet or not) have risen substantially and, with de-Globalization (or, as ***we*** call it, "Regionalization"), the cost of On-shoring and Near-shoring (while something they ***should*** have thought of and done a **long** ***time*** ago) will be higher. With demand beginning to subside, they won't be able to pass these costs along as they have and many will (most likely) face flat or declining earnings this year.

To reiterate, we know – if you want the potential of greater reward – one must take greater risk. But I have two questions. First, does the size or amount of risk ***truly*** coincide with the magnitude of the reward – and can that relationship be captured by some mathematical formula? We know (for example) that, in times of crisis (like the Great Recession of 2008) all things "correlate" (that is, they **all** go ***down***). Yet, when people use terms like "Beta" and "Standard Deviation," they (clearly) think so – because "Beta" (for them) is an attempt to measure how an individual asset will move when the overall Stock Market (say) increases or decreases. They use this to come up with an "Expected Rate of Return" – while "Standard Deviation" (typically illustrated by scattergrams around some trendline, like the one used by our Fed for their infamous "Dot Plots") is a measure of the variation a set of values (supposedly) *exhibits*, relative to some "*mean*." Again – with the "Safe Haven" of bonds proving to be one of the worst-performing Asset Classes last year – what most people consider "Low Risk" and "Non-Correlating" no longer ***are*** and formulas like these can (in my opinion) be misleading and (possibly) meaningless. In other words, while there may be patterns which (from time to time) hold true, it doesn't prove one (or even a series of) events will **necessarily** or ***inevitably*** cause another to occur, in a world as complicated as the one in which we live.

Most agree: the "***Risk Free***" Rate of Return is the yield on the 1-year Treasury, because it's a short-term measure – and because Principal and Interest are guaranteed by the Full Faith & Credit of the world's strongest nation (the US). Yet we know the old "60/40" Rule (where one allocates 60% to stock and 40% bonds, to mitigate risk) is no longer viable (in a low or zero-interest-rate world) – to the point where (even) firms like

Blackrock are (now) advising people to steer clear.

Nevertheless, most people ***do*** turn to formulas (of one sort or another), like the Capital Asset Pricing Model ("CAPM"), perhaps because it gives them a place to ***start***. But if/when they ***do***, it's important to remember this ***caveat*** – that they ***all*** rest on two ***Assumptions***. First, that Markets are "**efficient**" and, second, they're dominated by "**rational**" investors. Both presume the Markets are populated by sophisticated, well-informed Buyers and Sellers (which I question), because ***everyone*** begins to form Biases at an early age (based on their own, unique experiences) and, based on those biases, they begin making certain Assumptions which, for the rest of their lives, influence ***all*** their subsequent decisions. This skews things. And (then) add Self-Interest and Self-Justification (which I discussed in my EQUUS article, "What I Think I Know") and (knowingly or not) those decisions may no longer apply or pertain to the "real" world.

Again, our **mission** is to help Clients make ***informed*** decisions, whatever stage of life they're in – and one of the most important things is to start by understanding what "**Risk**" means, for ***you***. *So* instead, I think a better (or, at least, a more ***helpful***) way to think of things is in the context of "***Acceptable***" and "**UN***acceptable*" Risk.

Some risks seem obvious, like the difference between a multi-billion-dollar, global company (like an Apple or Alphabet) and a "fill-in-the-blank" SPAC or start-up – one which (maybe) has only one product and hasn't yet reached profitability, by the time it goes Public.

Of course, the more "Red Flags" a company has, the greater the risk **most *likely*** is – but this doesn't (necessarily) mean the risk should be deemed "unacceptable." The greater your expected reward, the more red flags you (as an investor) should be ***willing*** to accept. But it should ***certainly*** cause you to ask more questions, before making the investment – and to consider your particular circumstances; obligations; timeline; and financial wherewithal, overall, more carefully.

Always follow the **Carpenter's Rule**, remembering to **Measure Twice; Cut Once**. But the truth ***is*** – while different investors have different levels of tolerance – the only time they agree (for ***sure***) is when things go **wrong**. ***Nobody*** likes it when things go ***down***.

So, in light of everything we just said, where do we go from here?

Let's start with Commodities. I've long liked Gold and Silver, of course – and, in recent years, have added Bitcoin as another (perhaps ultimate) hedge against Fiat currencies – where Central Banks print endless amounts of "money," without concern for its longer-term impact on inflation, debt and debt service. But as the war in Ukraine continues (and, possibly, escalates); with Saudi Arabia "threatening" to trade in currencies other than the dollar (which they haven't done since Nixon took us off the Gold Standard in 1971 – and his Treasury Secretary, William Simon, convinced the Saudis to sell oil in dollars); and (now) the "post-Covid" re-opening of China, with the start of their Lunar New Year – it seems likely Gold ***will*** exhibit (if not a resurgence) then (at least) continued demand. Also, with the battle now underway to raise our ***own*** Debt Limit, foreign investors (especially) may begin to feel uneasy about the strength of the dollar – which could create *another* tailwind for precious metals.

And (finally) there's Brazil and Argentina, engaging in talks to create a common currency. They tried this back in 1987 – with something called the "Gaucho" – but they've (actually) been at it for years, looking for ways to reduce their reliance on the dollar (which, as we've said before, gives us significant advantages). But as one person recently said – for ***Brazil*** to do so – "it's like opening a joint bank account with that unemployed, deadbeat friend who owes everyone money."[2] Just last year, ***Argentina*** (which I *adore*, from my days playing polo there) reached a deal with the IMF to refinance their recent, $44 billion *bailout* – and Argentines have long stashed billions of dollars in overseas vaults and accounts because, after decades of this, they know better than to trust the value of their own peso. But the government keeps trying and, with Lula (now out of jail and back in power in Brazil), why not? Plus, with new EV incentives, here and overseas – with battery storage; solar *farms*; and our own efforts to improve the GRID, with money from our recent "Infrastructure" Bill – that should drive demand for metals, in general. So, yes: hold onto that gold.

For *some*, given we've had a nice rally over the past month or so, it might make sense to skim a little "cream" off the "top" and shift a bit more into Cyclicals and Defense, which *may* offer greater value. In 1934, in his classic book, "Security Analysis," Benjamin Graham said, "you buy when the company is trading at or below book value

[2] "Brazil and Argentina Discuss Creation of Common Currency," by Samantha Pearson and Ryan Dube, The Wall Street Journal, January 23, 2023

(relative to its assets), when it's cheaper to buy than build." This is what many Private Equity firms have found to be a great way to amplify wealth – to turn around poorly managed businesses with great assets. And even though interest rates *have* risen substantially, over the past 12 months, they're still lower than they were in the 70s and 80s, when Private Equity flourished – and, with the Economy (now) on the verge of Recession, this could create opportunities for them, to pick up the pace.

But Clients also know, in general, I like to **let our Winners run** and – using a more ***Concentrated*** Portfolio approach I explained in my EQUUS Report, titled "**The *Pareto* Principle**" – I value the power of **Compounding** which (my Partner agrees) may be one of the great ***"Wonders*** of the **World."**

On the other hand, with the 10-year Treasury hovering around 3.5%, I'm not ***quite*** so sure which way I think **rates** will go from here. Lacy Hunt at Hoisington Management seems (as usual) to be making a good argument for rates going lower – especially with the velocity of money in decline and the Fed (still) determined to choke off inflation – which (if they do) probably ***will*** put us in Recession. My ***hope*** (of course) is they'll pause and give what they've already done a chance to work – but this is certainly what the Bond Market is saying, with its inverted Yield Curve (where short-term rates are higher than longer-term ones). It's true that 60% of our CPI is derived from Service Sector inflation, which is highly dependent on the cost of **Labor**[3] – but that too is now beginning to show signs of slowing, with an increasing number of our biggest Tech companies beginning to announce a steady stream of layoffs.

But according to Strategas,[4] nearly 50% of our outstanding, sovereign debt is maturing in the next three years and, today, the weighted average cost is only 1.8%. With the yield on Treasuries, with a maturity of 2 years or less, now at or near 4.5% – on the Trillions of dollars we'll be rolling over – that could cause significant, upward pressure on rates (not to mention the **cost** to ***Taxpayers***). So I'm a little nervous about "backing up the truck" – even though yields are more enticing (now) than they have been in years. I'm still more inclined to stick with higher-yielding, Floating Rate debt, when it comes to bonds and Fixed Income.

Again, for *some*, it may make sense to take any further Rallies as an opportunity to

[3] U.S. Bureau of Labor Statistics (bls.gov)
[4] "12 Things Investors Might Not Know But Should," Jason De Sena Trennert, Strategas Partners, January 23, 2023

increase Reserves. "Habits" (when it comes to money) are as important as they are for health, career and family – and (if you didn't *last* year) make sure to put money aside for a "Rainy Day." Make sure you pay yourself *first* – first, by paying off any debt or Credit Card balances; then, by establishing a decent Cash Buffer to protect you and your family, in the event of an Economic downturn or something unexpected. ***Then*** you should be "good to go," to invest for the longer term.

And remember to check your emotions (at least once a year) and your tolerance for Risk. Make sure you're in a frame of mind where you can resist the temptation to give in to fear. It's not that you should ***ignore*** important warning signs – whether of "Detours Ahead" or (god forbid) cliffs – in the belief things will *always* go up. **Clearly**, they ***don't***. And, for *those* times, we want to be **certain** we ***always*** have plenty of cash, so you're **never** forced to sell. Make a plan; work a plan – and stay focused on whatever your reasons were for investing in something in the first place. At any given time, if those reasons still hold true – and Management is doing what they promised – don't let yourself be shaken out.

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